

CHAPTER 4

FIELD WORK STANDARDS FOR FINANCIAL AUDITS

INTRODUCTION

4.1 Generally accepted government auditing standards (GAGAS) incorporate the American Institute of Certified Public Accountants' (AICPA) generally accepted field work standards for audits and the related AICPA Statements on Auditing Standards (SASs) unless the Comptroller General of the United States excludes them by formal announcement.¹ This chapter identifies the AICPA field work standards and prescribes additional standards for applying the AICPA field work standards for financial audits performed in accordance with GAGAS. This chapter concludes with guidance that auditors should give consideration to when performing financial audits in accordance with GAGAS.

4.2 Financial audits consist of all work performed under the AICPA's generally accepted auditing standards and governed by the AICPA SASs, which interpret the standards. Such work performed in a government environment primarily includes audits of financial statements. The SASs also govern other types of services which may also be performed in a government environment, such as compliance auditing, issuing special reports,³ audits of service organizations, reviews of interim

¹To date, the Comptroller General has not excluded any field work standards or statements on auditing standards.

²The term "financial statement" refers to a presentation of financial data, including accompanying notes, derived from accounting records and intended to communicate an entity's economic resources or obligations at a point in time or the changes therein for a period of time in conformity with an identifiable framework, such as generally accepted accounting principles (GAAP) or an other comprehensive basis of accounting (OCBOA). Audits of financial statements include all services governed by the AICPA's SASs for which the auditors are engaged to provide a level of assurance on the fair presentation of financial statements in accordance with a stated criteria.

³Special reports apply to auditors' reports issued in connection with the following: (1) financial statements that are prepared in conformity with a comprehensive basis of accounting other than generally accepted accounting principles; (2) specified elements, accounts, or items of a financial statement; (3) compliance with aspects of contractual agreements or regulatory requirements related to audited financial statements; (4) financial presentations to comply with contractual agreements or regulatory provisions; or (5) financial information presented in prescribed forms or schedules that require a prescribed form of auditor's report.

financial information, and issuing letters to underwriters and certain other requesting parties. These other services may be performed in conjunction with an audit of financial statements.

FIELD WORK STANDARDS

4.3 The three AICPA generally accepted standards of field work are as follows.

- a. The work is to be adequately planned, and assistants, if any, are to be properly supervised.**
- b. A sufficient understanding of internal control is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.**
- c. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.**

ADDITIONAL GAGAS FIELD WORK STANDARDS

4.4 GAGAS prescribe additional standards for applying the AICPA three generally accepted AICPA field work standards which go beyond the requirements contained in the AICPA's SASs. Auditors must comply with these additional standards when citing GAGAS in their audit reports. The additional GAGAS relate to

- a. auditor communication (see paragraphs 4.6 through 4.13),**
- b. considering the results of previous audits (see paragraphs 4.14 through 4.16),**

- c. noncompliance with provisions of contracts and grants (see paragraphs 4.17 through 4.19), and
- d. audit documentation (see paragraphs 4.20 through 4.24).

4.5 This chapter concludes with guidance auditors should give consideration to when performing financial audits in accordance with GAGAS for the following areas:

- a. audit risk and materiality (see paragraphs 4.26 and 4.27),
- b. internal control over safeguarding of assets (see paragraphs 4.28 through 4.33),
- c. internal control over compliance (see paragraphs 4.34 through 4.36), and
- d. professional judgment concerning possible fraud and illegal acts (see paragraphs 4.37 through 4.39).

AUDITOR COMMUNICATION

4.6 An additional standard related to auditor communication for financial audits performed in accordance with GAGAS is:

Auditors should communicate information regarding the nature of services and level of assurance provided to not only officials of the audited entity, but also to the individuals contracting for or requesting the audit services, and the audit committee or other equivalent oversight body.

4.7 AICPA standards and GAGAS require auditors to establish an understanding with the client and to communicate with audit committees. GAGAS broaden the parties with whom auditors must communicate with during the planning stages of a financial audit to reduce the risk that the needs or

expectations of the parties involved may be misinterpreted. Auditors should use their professional judgment to determine the form, content, and frequency of the communication, although written communication is preferred, and should document the communication. Auditors may use an engagement letter, if appropriate, to communicate the information.

4.8 Auditors should communicate their responsibilities for the engagement to the appropriate officials of the audited entity, which may include

- a.** the head of the audited entity,
- b.** the audit committee or board of directors or other equivalent oversight body in the absence of an audit committee, and
- c.** the individual who possesses a sufficient level of authority and responsibility for the financial reporting process, such as the chief financial officer.

4.9 In situations where auditors are performing the audit under a contract with a party other than the officials of the audited entity, or pursuant to a third-party request, auditors should also communicate with the individuals contracting for or requesting the audit, such as contracting officials or legislative members or staff. When auditors are performing the audit pursuant to a law or regulation, auditors should communicate with the legislative members or staff who have oversight of the auditee.⁴ Auditors should coordinate communications with the responsible government audit organization and/or management of the audited entity, and may use the engagement letter to keep interested parties informed.

4.10 In communicating the nature of services and level of assurance provided, auditors should specifically address their planned work related to testing compliance with laws and regulations and

⁴This requirement applies only to situations where the law or regulation specifically identifies the entity to be audited, such as an audit of a specific agency's financial statements required by the Chief Financial Officers Act, as expanded by the Government Management Reform Act of 1994. Situations where the audit of financial statements mandate applies to entities not specifically identified, such as audits required by the Single Audit Act Amendments of 1996, are excluded.

internal control over financial reporting. During the planning stages of an audit, auditors should communicate their responsibilities for testing and reporting on compliance with laws and regulations and internal control over financial reporting. Such communication should include the nature of any additional testing of compliance and internal control required by laws and regulations or otherwise requested, and whether the auditors are planning on providing opinions on compliance with laws and regulations and internal control over financial reporting.

4.11 To assist in understanding the limitations of auditors' responsibilities for testing and reporting on compliance and internal control over financial reporting, auditors may want to contrast those responsibilities with other audits of compliance and controls. The discussion in paragraphs 4.12 and 4.13 may be helpful to auditors in explaining their responsibilities for testing and reporting on compliance with laws and regulations and internal control over financial reporting to officials of the audited entity and other interested parties.

4.12 Tests of compliance with laws and regulations and internal control over financial reporting in a financial audit contribute to the evidence supporting the auditors' opinion on the financial statements or other conclusions regarding financial data. However, such tests generally are not sufficient in scope to opine on compliance or internal control over financial reporting. To meet certain audit report users' needs, laws and regulations sometimes prescribe testing and reporting on compliance and internal control over financial reporting to supplement coverage of these areas.⁵

4.13 Even after auditors perform and report the results of additional tests of compliance and internal control over financial reporting required by laws and regulations, some reasonable needs of report users still may be unmet. Auditors may meet these needs by performing further tests of compliance

⁵For example, when engaged to perform audits under the Single Audit Act Amendments of 1996 for state and local government entities and nonprofit entities that receive federal awards, auditors should be familiar with the Office of Management and Budget (OMB) Circular A-133 on single audits. The act and circular include specific audit requirements, mainly in the areas of compliance with laws and regulations and internal control, that exceed the minimum audit requirements in the standards in chapters 4 and 5 of this document. Audits conducted under the Chief Financial Officers Act of 1990, as expanded by the Government Management Reform Act of 1994, also have specific audit requirements prescribed by OMB in the areas of compliance and internal control. Many state and local governments have additional audit requirements.

and internal control in either of two ways:⁶

- a. supplemental (or agreed-upon) procedures or
- b. examination, resulting in an opinion.

CONSIDERING THE RESULTS OF PREVIOUS AUDITS

4.14 An additional standard for financial audits performed in accordance with GAGAS is:

Auditors should consider the results of previous audits and follow up on known significant findings and recommendations, including those related to reportable conditions, identified in previous audits reports that relate to the objectives of the audit being undertaken.

4.15 Auditors should perform such follow-up to determine whether officials of the audited entity have taken appropriate corrective actions. In addition to following up on significant reported findings and recommendations⁷ from previous financial audits, auditors should consider significant findings identified in attestation engagements, performance audits, or other studies if these findings could materially affect the results of the financial audit. For example, an audit report on an entity's computerized information systems may contain significant findings that could relate to the financial audit if the entity uses such systems to process its accounting information. In any event, auditors need to make judgments about the extent of follow-up needed and the appropriate disclosure of uncorrected significant findings and recommendations from prior audits that affect the audit objectives.

⁶Such work is generally performed under the AICPA's Statements on Standards for Attestation Engagements. See chapter 6 for a discussion of the standards used when performing attestation engagements.

⁷Significant findings and recommendations are those matters that, if not corrected, could affect the results of the auditors' work and users' conclusions about those results.

4.16 Providing continuing attention to significant findings and recommendations is important to ensure that the benefits of audit work are realized. Ultimately, the benefits of audit work occur when audit findings are resolved through meaningful and effective corrective action taken in response to the auditors' findings and recommendations. Officials of the audited entity are responsible for resolving audit findings and recommendations directed to them, and for having a process to track their status. If officials of the audited entity do not have such a process, auditors may wish to establish their own process.

NONCOMPLIANCE WITH PROVISIONS OF CONTRACTS AND GRANT AGREEMENTS

4.17 The additional standard related to compliance with provisions of contracts and grant agreements for financial audits performed in accordance with GAGAS is:

Auditors should design the audit to provide reasonable assurance of detecting material misstatements of financial statements or other financial data resulting from noncompliance with provisions of contracts or grant agreements that have a direct and material effect on the determination of financial statement amounts. If specific information comes to the auditors' attention that provides evidence concerning the existence of possible noncompliance that could affect financial data significant to the audit objectives or that could have a material indirect effect on the financial statements, auditors should apply audit procedures specifically directed to ascertaining whether noncompliance has occurred or is likely to have occurred.

4.18 AICPA standards and GAGAS require auditors to assess the risk of material misstatements of financial statements due to fraud and should consider that assessment in designing the audit procedures to be performed.⁸ Auditors are also required to design the audit to provide reasonable assurance of detecting material misstatements resulting from direct and material illegal acts to be

⁸Two types of misstatements are relevant to the auditors' consideration of fraud in an audit of financial statements—misstatements arising from fraudulent financial statements and misstatements arising from misappropriation of assets. The primary factor that distinguishes fraud from error is whether the underlying action that results in the misstatement in the financial statements is intentional or unintentional.

aware of the possibility that indirect illegal acts may have occurred. Under GAGAS, the term noncompliance, however, has a broader meaning than fraud and illegal acts. Noncompliance includes not only fraud and illegal acts, but also violations of provisions of contracts or grant agreements.

4.19 Under GAGAS, auditors have the same responsibilities for detecting material misstatements arising from other types of noncompliance as they do for detecting those arising from fraud and illegal acts. Direct and material noncompliance is noncompliance having a direct and material effect on the determination of financial statement amounts or could have a significant effect on other financial data needed to achieve audit objectives. Auditors should design the audit to provide reasonable assurance of detecting material misstatements resulting from direct and material noncompliance with provisions of contracts or grant agreements. Indirect noncompliance is noncompliance having material but indirect effects on financial statements or other financial data needed to achieve audit objectives. If specific information comes to the auditors' attention that provides evidence concerning the existence of possible noncompliance that could have a material indirect effect on the financial statements or significant indirect effect on other financial data need to achieve audit objectives, auditors should apply audit procedures specifically directed to ascertaining whether that noncompliance has occurred or is likely to have occurred.

AUDIT DOCUMENTATION

4.20 An additional standard related to audit documentation for financial audits performed in accordance with GAGAS is:

Audit documentation should contain sufficient information to enable an experienced reviewer, who has had no previous connection with the audit, to ascertain from the audit documentation the evidence that supports the auditors' significant judgments and conclusions. Audit documentation that supports significant findings, conclusions, and recommendations should be complete before auditors issue their report.

4.21 AICPA standards and GAGAS require auditors to prepare and maintain audit documentation. The form and content of audit documentation should be designed to meet the circumstances of the particular audit. The information contained in audit documentation constitutes the principal record of the work that the auditors have performed and the conclusions that the auditors have reached. The quantity, type, and content of audit documentation is a matter of the auditors' professional judgment. However, audits performed in accordance with GAGAS are subject to review by other reviewers and by oversight officials more frequently than audits done in accordance with AICPA standards. Thus, whereas AICPA standards cite two main purposes of audit documentation--providing the principal support for the audit report and aiding auditors in performing and supervising the audit--audit documentation serves an additional purpose in audits performed in accordance with GAGAS. Audit documentation allows for the review of audit quality by providing the reviewer documentation, either in written or electronic formats, of the evidence supporting the auditors' significant judgments and conclusions.

4.22 Audit documentation for financial audits performed under GAGAS should contain the following.

- a.** The objectives, scope, and methodology, including sampling and other selection criteria used.
- b.** Documentation of the auditor's determination that certain additional government auditing standards do not apply or that an applicable standard was not followed, the reasons therefore, and the known effect that not following the standard had, or could have, on the audit.
- c.** Documentation of the work performed to support significant judgments and conclusions, including descriptions of transactions and records examined that would enable an experienced reviewer to examine the same transactions and records.⁹
- d.** Auditors' basis for assessing control risk at the maximum level for assertions related to material

⁹ Auditors may meet this requirement by listing voucher numbers, check numbers, or other means of identifying specific documents they examined. Auditors are not required to include copies of documents they examined as part of the audit documentation, nor are auditors required to list detailed information from those documents.

account balances, transaction classes, and disclosure components of financial statements when such assertions are significantly dependent upon computerized information systems by addressing (1) the ineffectiveness of the design and/or operation of the controls, or (2) the reasons why it would be inefficient to test the controls.

e. The consideration that the planned audit procedures are designed to achieve audit objectives when evidential matter obtained is highly dependent on computerized information systems and is material to the audit objective, and the auditors are not relying on the effectiveness of internal control over those computerized systems that produced the information. The audit documentation should specifically address (1) the rationale for determining the nature, timing, and extent of planned audit procedures; (2) the kinds and competence of available evidential matter produced outside a computerized information system; and (3) the effect on the audit report if evidential matter to be gathered does not afford a reasonable basis to achieve the audit objectives.¹⁰

f. Evidence of supervisory reviews of the work performed.

4.23 Underlying GAGAS audits is that federal, state, and local governments and other organizations cooperate in auditing programs of common interest so that auditors may use others' work and avoid duplicate audit efforts. In addition, audits performed in accordance with GAGAS are subject to quality control and assurance reviews. Auditors should make arrangements to make audit documentation available, upon request, in a timely manner to other auditors or reviewers. Contractual arrangements for GAGAS audits should provide for full and timely access to audit documentation to facilitate reliance by other auditors on the auditors' work, as well as reviews of audit quality control and assurance.

4.24 Audit organizations should establish reasonable policies and procedures for the safe custody and retention of audit documentation for a time sufficient to satisfy legal and administrative requirements. If audit documentation is only retained electronically, the audit organization should ensure that the electronic documentation is capable of being accessed throughout the specified

¹⁰This documentation requirement does not increase the auditors' responsibility for testing internal control but is intended to assist the auditor in ensuring that audit objectives are met and audit risk is reduced to an acceptable level.

retention period established for audit documentation and is safeguarded through sound computer security.

ADDITIONAL CONSIDERATIONS
FOR FINANCIAL AUDITS PERFORMED
IN ACCORDANCE WITH GAGAS

4.25 As discussed in chapter 1, financial audits contribute to making governments more accountable for the use of public resources and the delivery of services. Because of the increased accountability associated with government audits, auditors performing financial audits in accordance with GAGAS should consider the following guidance related to audit risk and materiality (see paragraphs 4.26 and 4.27), internal control over safeguarding of assets (see paragraphs 4.28 through 4.33), internal control over compliance (see paragraphs 4.34 through 4.36), and professional judgment concerning possible fraud and illegal acts (see paragraphs 4.37 and 4.39).

Audit Risk and Materiality

4.26 The AICPA standards and GAGAS require that the work is to be properly planned, and auditors should consider audit risk and materiality, among other matters, in determining the nature, timing, and extent of auditing procedures and in evaluating the results of those procedures. Auditors' consideration of audit risk and materiality is a matter of professional judgment and is influenced by their perception of the needs of a reasonable person who will rely on the financial statements. Materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations.

4.27 In an audit of a government entity or an entity that receives government assistance, auditors may need to set lower materiality levels than in audits in the private sector because of the public accountability of the audited entity, the various legal and regulatory requirements, and the visibility and sensitivity of government programs, activities, and functions.

Internal Control Over
Safeguarding of Assets

4.28 Safeguarding of assets is an internal control objective. that is especially important in performing financial audits of governmental entities or others receiving government funds.¹¹ Given the public accountability for stewardship of resources, safeguarding of assets permeates control objectives and components as defined by the AICPA standards and GAGAS.

4.29 As applied to financial audits, internal control over safeguarding of assets constitutes a process, effected by an entity's governing body, management, and other personnel designed to provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

4.30 Internal control over the safeguarding of assets relates to the prevention or timely detection of unauthorized transactions and unauthorized access to assets that could result in losses that are material to the financial statements, such as when unauthorized expenditures or investments are made, unauthorized liabilities are incurred, inventory is stolen, or assets are converted to personal use. Such controls are designed to help ensure the use of and access to assets are in accordance with management's authorization. Authorization includes approval of transactions in accordance with control activities established by management to safeguard assets, such as establishing and complying with requirements for extending and monitoring credit or making investment decisions, and related documentation. Control over safeguarding of assets is not designed to protect against loss of assets arising from inefficiency or from management's operating decisions, such as incurring expenditures for equipment or material that proves to be unnecessary or unsatisfactory.

4.31 AICPA standards and GAGAS require auditors to obtain a sufficient understanding of internal control to plan the audit. They also require auditors to plan the audit to provide reasonable assurance of detecting material fraud, including material misappropriation of assets. Because preventing or

¹¹ Auditors should apply the guidance contained in this section to other types of financial audits to the extent it is applicable to the nature of the engagement.

detecting material misappropriations is an objective of control over safeguarding of assets, understanding this type of control can be essential to planning the audit.

4.32 Control over safeguarding of assets is not limited to preventing or detecting misappropriations. It also helps prevent or detect other material losses that could result from unauthorized acquisition, use, or disposition of assets. Such controls include, for example, the process of assessing the risk of unauthorized acquisition, use, or disposition of assets and establishing control activities to help ensure that management directives to address the risk are carried out. Such control activities would include permitting acquisition, use, or disposition of assets only in accordance with management's general or specific authorization, including compliance with established control activities for such acquisition, use, or disposition. They would also include comparing existing assets with the related records at reasonable intervals and taking appropriate action with respect to any differences. Finally, controls over safeguarding of assets against unauthorized acquisition, use, or disposition also relate to making available to management information it needs to carry out its responsibilities related to prevention or timely detection of such unauthorized activities, as well as mechanisms to enable management to monitor the continued effective operation of such controls.

4.33 Understanding the control over safeguarding of assets can help auditors assess the risk that financial statements could be materially misstated. For example, an understanding of the audited entity's control over the safeguarding of assets can help auditors recognize risk factors such as

- a.** failure to adequately monitor decentralized operations;
- b.** lack of control over activities, such as lack of separation of duties or approval for major transactions;
- c.** lack of control over computerized information systems, such as a lack of control over access to applications that initiate or control the movement of assets;

- d. failure to develop or communicate adequate control activities for security of data or assets, such as allowing unauthorized personnel to have ready access to data or assets; and
- e. failure to investigate significant unreconciled differences between reconciliations of a control account and subsidiary records.

Internal Control Over Compliance

4.34 Governmental entities are subject to a variety of laws and regulations that affect their financial statements or other financial data, which is a major factor distinguishing governmental accounting from private-sector accounting. For example, such laws and regulations may address the required fund structure, procurement or debt limitations, or authority for transactions. Accordingly, compliance with such laws and regulations may have a direct and material effect on the determination of amounts in the financial statements of governmental entities. Likewise, entities that receive government assistance, such as contractors, nonprofit entities, and other nongovernmental entities, are also subject to regulations, contract provisions, or grant agreements that could have a direct and material effect on their financial statements. Management, of both governmental entities and others receiving governmental assistance, is responsible for ensuring that the entity complies with not only the laws and regulations but also contract provisions and grant agreements applicable to its activities. That responsibility encompasses the identification of applicable laws, regulations, contract provisions, and grant agreements, as well as the establishment of controls designed to provide reasonable assurance that the entity complies with those laws, regulations, contract provisions, and grant agreements.

4.35 AICPA standards and GAGAS require auditors to design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from noncompliance that have a direct and material effect on the determination of financial statement amounts. To meet this requirement, auditors should have an understanding of internal control relevant to financial statement assertions affected by those laws, regulations, contract provisions, or grant agreements. Auditors may find it necessary to use the work of legal counsel in (1) determining

which laws and regulations might have a direct and material effect on the financial statements, (2) designing tests of compliance with laws and regulations, and (3) evaluating the results of those tests.¹² Auditors also may find it necessary to use the work of legal counsel when an audit requires testing compliance with provisions of contracts or grant agreements. Depending on the circumstances of the audit, auditors may find it necessary to obtain information on compliance matters from others, such as investigative staff, audit organizations, and officials of government entities that provided assistance to the audited entity, and/or the applicable law enforcement authority.

4.36 AICPA standards and GAGAS require that auditors use their understanding of internal control relevant to financial statement assertions affected by laws and regulations to identify types of potential misstatements, consider factors that affect the risk of material misstatement, and design substantive tests. GAGAS extends this requirement to include contract provisions and grant agreements. In applying this requirement, the following factors may influence the auditors' assessment of control risk:

- a.** management's awareness or lack of awareness of applicable laws, regulations, contract provisions, or grant agreements;
- b.** policy of the audited entity regarding such matters as acceptable operating practices and codes of conduct; and
- c.** assignment of responsibility and delegation of authority to deal with such matters as organizational goals and objectives, operating functions, and regulatory requirements.

¹²AICPA standards provide guidance for auditors who use the work of a specialist who is not a member of their staff.

Professional Judgment Concerning
Possible Fraud and Illegal Acts

4.37 Under AICPA standards and GAGAS, auditors are responsible for being aware of the characteristics and types of potentially material fraud that could be associated with the area being audited so that they can plan the audit to provide reasonable assurance of detecting material misstatements of the financial statements due to fraud.

4.38 Auditors should exercise professional judgment in pursuing indications of possible fraud and illegal acts so as not to interfere with potential future investigations, legal proceedings, or both. Under some circumstances, laws, regulations, or policies may require auditors to report indications of certain types of fraud or illegal acts to law enforcement or investigatory authorities before extending audit steps and procedures. Auditors may also be required to withdraw from or defer further work on the audit or a portion of the audit in order not to interfere with an investigation.

4.39 An audit made in accordance with GAGAS will not guarantee the discovery of fraud or illegal acts or contingent liabilities resulting from them. Nor does the subsequent discovery of illegal acts committed during the audit period mean that the auditors' performance was inadequate, provided the audit was made in accordance with GAGAS.